Center for American Progress
1333 H Street NW, Suite 100E
Washington, DC 20005
202.682.1611
americanprogress.org

February 6, 2023

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Principles for Climate-Related Financial Risk Management for Large Financial Institutions

Dear Ms. Misback:

The Center for American Progress ("CAP") welcomes the opportunity to submit comments to the Board of Governors of the Federal Reserve System's ("Board" or "Fed") notice and request for comment titled *Principles for Climate-Related Financial Risk Management for Large Financial Institutions* ("the Principles"). CAP is an independent, nonpartisan policy institute dedicated to improving the lives of all Americans, through bold, progressive leadership and action. In proposing these Principles, the Board joins its fellow banking regulators the Office of the Comptroller of the Currency ("OCC") and Federal Deposit Insurance Corporation ("FDIC") in acknowledging its important role in understanding and addressing climate-related financial risks.

More frequent and destructive billion-dollar extreme weather disasters fueled by climate change caused over $165 billion in damages in 2022 alone.[1] These physical risks imposed by a worsening climate crisis can disrupt financial institutions' abilities to effectively serve U.S. households, businesses, and the broader economy, in addition to threatening communities, livelihoods, and public health and safety. Additionally, firms must adapt to the economy-wide shift towards clean renewable energy sources. As consumers and investors shift preferences away from carbon-intensive industries, assets held by companies in those industries may be at risk of becoming partially or fully stranded and, in turn, affect companies' ability to meet their financial obligations.

While the effects of climate change increasingly pose risks to the financial sector and wider economy, the federal banking regulators must ensure supervised institutions have the guidance necessary to manage and mitigate their exposure to such risks. The events of the 2007-2008 Financial Crisis highlighted the highly

[1] National Centers for Environmental Information, "Billions," 2023, available at https://www.ncei.noaa.gov/access/billions/.

interconnected nature of the U.S. financial system and the vulnerabilities of firms' risk management frameworks. As a result, Congress entrusted the federal banking regulators, including the Board, with ensuring that banks do not engage in "unsafe or unsound" practices, which can have broader economic consequences.[2] The Fed also has a responsibility to monitor "emerging threats to the stability of the United States financial system"[3] as a member of the Financial Stability Oversight Council ("FSOC").

We commend the Board for joining efforts by the OCC and FDIC to help examiners and banks better understand and address climate-related financial risks. As the Fed finalizes its proposal, it is important that the insights gleaned by supervisors and banks themselves be used to inform future, more technical guidance. Climate-related financial risks faced by banks are quickly evolving; thus, regulatory and supervisory frameworks must be nimble. In addition to the observations above, we provide the following comments on the questions posed in the Principles document.

Question 1: In what ways, if any, could the draft principles be revised to better address challenges a financial institution may face in managing climate-related financial risks?

Scope of Principles

As the Principles acknowledge, "all financial institutions, regardless of size, may have material exposures to climate-related financial risks."[4] The Principles are high-level enough to apply to all banks, not just those with over $100 billion in total assets. However, the Fed should consider how implementation may look different for the largest banks than for a regional bank based on considerations such as asset size, location, and business model, among other factors. Regional banks, with portfolios that may not be as diversified as those of larger institutions, may experience higher rates of failure and branch closures as a consequence of natural disasters that affect only one geographic area. Accordingly, safety and soundness concerns necessitate climate scenario analyses for smaller and mid-size institutions, as well. Those analyses may not need to be as rigorous as the ones for larger banks so long as they help institutions gain a better understanding of the climate risks they face and in turn, identify possible strategies to manage those risks.

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[2] Cornell Law School, "12 U.S. Code § 1818 - Termination of status as insured depository institution," available at https://www.law.cornell.edu/uscode/text/12/1818.
[3] Legal Information Institute, "12 U.S. Code § 5322 - Council authority" available at https://www.law.cornell.edu/uscode/text/12/5322.
[4] Federal Register, "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (2022), available at https://www.federalregister.gov/documents/2022/12/08/2022-26648/principles-for-climate-related-financial-risk-management-for-large-financial-institutions.

Understanding climate risk

As the Principles acknowledge, climate-related financial risks may resemble traditional ones that firms are familiar with addressing (e.g., credit, market, liquidity, operational, and legal / compliance risk). For instance, credit risk may arise as more intense and destructive extreme weather events affect real estate portfolios and impair borrowers' abilities to meet their financial obligations; liquidity risk occurs as climate-induced market volatility limits firms' access to stable funding sources.[5] Additionally, the Fed should help institutions understand options for reducing, mitigating, or otherwise managing their climate-related risks. These options could include, among others, incorporating climate-related financial risk management practices in all business lines, creating procedures by which climate-related issues may be escalated to the management or board level, and assisting counterparties in developing their own climate-related risk management or transition plans.

The Principles primarily focus on firms' individual capabilities to manage and mitigate climate-related financial risks. However, supervisors must also understand the extent to which firms create risk that threatens the health of the broader economy. For instance, the six largest U.S. banks, which would be covered under this Proposal, provided 29% of fossil fuel financing in 2021.[6] Continued and expanded financing of carbon-intensive sectors may contribute to greater greenhouse gas (GHG) emissions and exacerbate the climate crisis and extreme weather risk. More frequent, powerful, and destructive weather events linked to climate change risk future losses that can extend to other sectors of the economy.[7]

Along those lines, firms may be underestimating both their contribution and their exposure to climate risk. A recently published review of G-SIB "climate action plans" by Board staff found that most G-SIBs are not measuring their scope 3 emissions.[8] Moreover, a survey by the Carbon Disclosure Project estimated that the financial sector's scope 3 emissions are likely at least 700 times larger than their operational emissions.[9] Additionally, even banks that purport to estimate their scope 3 emissions may not fully internalize the risks of carbon-intensive assets on their balance sheets, since loans can be securitized and sold off to other

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[5] Bank For International Settlements," Climate-related risk drivers and their transmission channels" (2021), available at https://www.bis.org/bcbs/publ/d517.pdf.
[6] Banking Climate Chaos, "Banking on Climate Chaos: Fossil Fuel Finance Report 2022" (2022), available at https://www.ran.org/wp-content/uploads/2022/03/BOCC_2022_vSPREAD-1.pdf.
[7] Gregg Gelzinis, "Addressing Climate-Related Financial Risk Through Bank Capital Requirements," Center for American Progress, May 11, 2021, available at https://www.americanprogress.org/article/addressing-climate-related-financial-risk-bank-capital-requirements/.
[8] Board of Governors of the Federal Reserve System, "What are Large Global Banks Doing about Climate Change?" (2023), available at https://www.federalreserve.gov/econres/ifdp/files/ifdp1368.pdf.
[9] Carbon Disclosure Project, "The Time to Green Finance" (2022), available at "https://cdn.cdp.net/cdp-production/cms/reports/documents/000/005/741/original/CDP-Financial-Services-Disclosure-Report-2020.pdf?1619537981."https://cdn.cdp.net/cdp-production/cms/reports/documents/000/005/741/original/CDP-Financial-Services-Disclosure-Report-2020.pdf?1619537981.

entities. The Principles should encourage banks to measure the flow of emissions financed in a period of time.

Integrating climate risk into CAMELS ratings

The Fed uses the Uniform Financial Institutions Rating System, better known as CAMELS, "for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention or concern."[10] Fed examiners assign banks a score of 1 to 5 on six components ("capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk") and provide an overall composite score. Banks take their CAMELS ratings very seriously, and regulators use them to decide whether a bank holding company can engage in non-banking financial activities and how much to charge for insurance premiums.[11]

The Federal Financial Institutions Examination Council (FFIEC) has provided guidance on what factors examiners should consider when evaluating banks for each component, and climate risk may be easily incorporated.[12] The Fed should issue guidance explaining how its examiners will incorporate climate-related financial risks into its CAMELS ratings. For example, the FFIEC guidance explains that examiners should consider "balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities" when determining a bank's Capital Adequacy score.[13] Accordingly, the Fed should explain that examiners must consider whether its assets are at risk of losing value as markets transition away from fossil fuels. Similarly, the FFIEC guidance explains that examiners should consider "the adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities" to determine a bank's Management score, and examiners should consider whether the bank has sufficient policies addressing climate-related financial risk.[14]

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[10] Federal Financial Institutions Examination Council, "Uniform Financial Institutions Rating System," *Federal Register* 61 (245) (1996): 67021-67029, available at https://www.govinfo.gov/content/pkg/FR-1996-12-19/pdf/96-32174.pdf.

[11] See Legal Information Institute, "12 U.S. Code § 1843 - Interests in nonbanking organizations," available at https://www.law.cornell.edu/uscode/text/12/1843; Legal Information Institute, "12 U.S. Code § 1841 - Definitions," available at https://www.law.cornell.edu/uscode/text/12/1841; Legal Information Institute, "12 CFR § 327.16 - Assessment pricing methods," available at https://www.law.cornell.edu/cfr/text/12/327.16.

[12]Federal Financial Institutions Examination Council, "Uniform Financial Institutions Rating System," *Federal Register* 61 (245) (1996): 67021-67029, available at https://www.govinfo.gov/content/pkg/FR-1996-12-19/pdf/96-32174.pdf.

[13] Ibid, p. 67026.

[14] Ibid, p. 67027.

Tailoring guidance

The Fed should also consider (on a document-by-document basis) whether or how the Principles or expectations may be tailored to institutions' business lines, sizes, or location to ensure supervision is commensurate with the types of risk an institution faces. For example, institutions with high concentrations of mortgage loans will have different risk profiles from institutions with high concentrations of agricultural loans; institutions with high concentrations of mortgage loans in one area of the country (e.g., those that face different degrees of climate-related risk) will have different risk profiles from institutions in others.

Tailoring examiners' interactions with banks

Just as the Board should tailor its written guidance, its examiners' interactions with institutions should be similarly tailored. Some of the largest institutions are keenly aware of their climate-related risks and began taking steps to mitigate those risks even before the Board proposed its guidance. For these institutions, examiners' climate-related responsibilities should be focused on, for example, ensuring that institutions' managements have put forth policies and procedures based on the most recent scientific evidence on climate risk and that staff comply with those policies and procedures. However, for smaller institutions that may not have the resources to begin adapting to the realities of climate change, examiners should have conversations with institutions' boards and management so that they understand the climate-related risks they face and have basic information as to the range of possible responses.

Meeting public commitments

Importantly, the Principles state that, "boards and management should assure that any public statements about their institutions' climate-related strategies and commitments are consistent with their internal strategies and risk appetite statements." For instance, many of the firms that would be included under these Principles have signed on to the Global Financial Alliance for Net Zero ("GFANZ") committing to align operations to net-zero targets by 2050.[15] By failing to make measurable progress toward such goals, firms may open themselves up to reputational risk as customers who choose their banks, in part based on these pledges, may move their business away from these institutions. Second, publicly traded institutions that make climate commitments may face litigation under the securities laws for making materially false statements if they similarly fail to make significant progress on those commitments. Lastly, by failing to meet these goals, firms may further exacerbate climate-related financial risk. To help institutions avoid losses from these risks, the Fed should make clear that institutions that

[15] UN Environment Programme Finance Initiative, "Members Net-Zero Banking Alliance," available at https://www.unepfi.org/net-zero-banking/members/ (Last Accessed January 2023).

make public climate commitments must develop and implement credible strategies for fulfilling those commitments.

Additionally, those strategies should not rely on carbon offsets, which are "tradable 'rights'" or certificates linked to activities that lower the amount of carbon dioxide in the atmosphere."[16] There is deep concern that many carbon offsets, as currently designed, do not work.[17] To the extent institutions wish to rely on carbon offsets to meet their commitments, the Fed should ensure that efforts are in place to substantiate that those offsets result in the removal of carbon from the atmosphere.

Question 2: Are there areas where the draft principles should be more or less specific given the current data availability and understanding of climate-related financial risks? What other aspects of climate-related financial risk management, if any, should the Board consider?

Community Reinvestment Act regulations and fair lending

As the Proposal notes, "The adverse effects of climate change could also include a potentially disproportionate impact on the financially vulnerable, including low- to moderate-income ("LMI") and other disadvantaged households and communities."[18] Additionally, as staff at the Federal Reserve Bank of New York have noted, "low-income and minority Americans are limited in how they may adapt to climate change because they have less access to insurance and are less likely to have access to credit when needed."[19] Lastly, low-income communities and communities of color are disproportionately exposed to harmful local pollution associated with fossil fuel use and production.[20]

The Fed should work with the other federal banking agencies to update their Community Reinvestment Act ("CRA") rules to ensure that credit flows to LMI and other disadvantaged communities to help these communities reduce their fossil fuel emissions and protect themselves from climate impacts. Currently,

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[16] *See e.g.*, Angelo Gurgel, "Carbon Offsets," MIT Climate Portal, September 11, 2020, available at https://climate.mit.edu/explainers/carbon-offsets.
[17] *See e.g.*, Lisa Song and Paula Moura, "An Even More Inconvenient Truth: Why Carbon Credits for Forest Preservation May Be Worse Than Nothing," ProPublica, May 22, 2019, available at https://features.propublica.org/brazil-carbon-offsets/inconvenient-truth-carbon-credits-dont-work-deforestation-redd-acre-cambodia/.
[18] Federal Register, "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (2022), available at https://www.federalregister.gov/documents/2022/12/08/2022-26648/principles-for-climate-related-financial-risk-management-for-large-financial-institutions.
[19] Ruchi Avtar and others, "Understanding the linkages between climate change and inequality in the United States," Federal Reserve Bank of New York, November 2021, p. 5, available at https://www.econstor.eu/bitstream/10419/247914/1/sr991.pdf.
[20] Cathleen Kelley and Mikyla Reta, "Implementing Biden's Justice40 Commitment To Combat Environmental Racism, Center for American Progress, June 22, 2021, available at https://www.americanprogress.org/article/implementing-bidens-justice40-commitment-combat-environmental-racism/.

banking deserts often in central cities and rural areas are excluded from the benefits promised by the CRA because they are not in any institution's assessment area.[21] The Fed should update its CRA regulations to ensure that institutions with a nationwide presence direct investment into all underserved communities, not only those surrounding physical branches.

Further, a history of disinvestment in low-income communities and communities of color[22] has contributed to a predominance of climate-vulnerable structures, ill-equipped to withstand natural disasters.[23] The Fed should also explore a climate resilience and environmental justice finance mandate for the CRA, which could give institutions credit for providing loans for projects such as energy efficient and climate resilient affordable housing, installation of community solar energy projects, and other activities to reduce GHG emissions and local pollution and build community resilience to climate change.[24]

In line with its mandate to encourage financial institutions to "meet the credit needs" of the communities in which they serve,[25] the Fed must also understand how firms are balancing climate risk mitigation in underwriting, while still providing access to affordable credit for climate-affected communities. A number of laws to which banks are subject including the Equal Credit Opportunity Act, the Fair Housing Act, Community Reinvestment Act, and regulations thereunder prohibit discrimination based on several protected characteristics. [26]

To address such concerns, the Fed should leverage the expertise and guidance of its Division on Consumer and Community Affairs. Additionally, it should scrutinize banks' statistical models for analyzing fair lending and climate

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[21] Board of Governors of the Federal Reserve System, "Agencies issue joint proposal to strengthen and modernize Community Reinvestment Act Regulations," Press release, May 5, 2022, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220505a.htm.
[22] Lily Katz, "A Racist Past, a Flooded Future: Formerly Redlined Areas Have $107 Billion Worth of Homes Facing High Flood Risk—25% More Than Non-Redlined Areas," Redfin, March 21, 2021, available at https://www.redfin.com/news/redlining-flood-risk/.
[23] *See e.g.*, Jee Young Lee and Shannon Van Zandt, "Housing Tenure and Social Vulnerability to Disasters: A Review of the Evidence," Journal of Planning Literature, 2019, available at https://journals.sagepub.com/doi/10.1177/0885412218812080; "Struggling Against a Rising Tide: Sea Level Rise and Coastal Flooding Threaten Affordable Housing," (Princeton, NJ: Climate Central, 2020) available at https://assets.ctfassets.net/cxgxgstp8r5d/2nitlFrqBONFS2R44J7SLY/5c0c724f1d001be26c72cac05d859e1b/SEA LEVEL RISE AND COASTAL FLOODING THREATEN AFFORDABLE HOUSING.pdf.
[24] *See e.g.*, "RE: Community Reinvestment Act Proposed Rulemaking [87 FR 33884]," Center for American Progress, August 5, 2022, available at https://www.fdic.gov/resources/regulations/federal-register-publications/2022/2022-community-reinvestment-act-3064-af81-c-322.pdf; https://www.americanprogress.org/article/cra-meet-challenge-climate-change/.
[25] Legal Information Institute, "12 U.S. Code § 2901 - Congressional findings and statement of purpose," available at https://www.law.cornell.edu/uscode/text/12/2901.
[26] See Equal Credit Opportunity Act, Public Law 93, Sec. 495, Title V, 93rd Cong., 2nd sess. (October 28, 1974), available at https://www.congress.gov/bill/93rd-congress/house-bill/11221/text; Fair Housing Act, Public Law 90, Sec. 284, 90th Cong., 2nd sess. (April 11, 1968), available at https://www.congress.gov/bill/90th-congress/house-bill/2516/text; Community Reinvestment Act, Public Law 95, Sec. 128, 95th Cong., 1st sess. (October 12, 1977), available at https://www.congress.gov/bill/95th-congress/house-bill/6655/text.

risk to ensure outputs do not result in disparate treatment of LMI borrowers and borrowers of color. The Fed should also train examiners and enforcement officials to recognize where discrimination can occur and what equity considerations should be implemented as banks begin taking steps to address climate risks.

Finally, the Fed should issue guidance detailing how institutions may continue extending affordable credit to vulnerable communities in a safe and sound manner. The Fed should particularly focus on how institutions may safely lend for the purchase and installation of residential solar panels, which are the types of long-term, uncollateralized loans that institutions are traditionally reticent to make.

Scenario analysis

As the Principles note, climate scenario analysis ("CSA") is a forward-looking exercise through which firms can "identify[], measur[e], and manag[e] climate-related financial risks."[27] Moreover, CSA can and should be adapted to a bank's "size, complexity, business activity, and risk profile." Relatedly, the Fed recently published information on how its pilot microprudential climate scenario analysis will be conducted for the six largest U.S. banks.[28] In administering its own CSA, the Fed can enhance its understanding of firms' exposure to climate risk as well as common limitations or themes that may require further attention by examiners and firms. However, as presently designed, the CSA is too limited to capture the full scope of risks firms face.

The physical risk module will focus only on "estimating the effect of specific scenarios on residential real estate and commercial real estate (CRE) loan portfolios over a one-year horizon in 2023;" the transition risk module will analyze "corporate loans and CRE portfolios over a 10-year horizon." Future iterations of a CSA should reflect the reality that climate risk affects every sector. Along those lines, a robust CSA should also assess a firms' trading books, as climate-related events can affect underlying financial instruments and create market risk. Additionally, in many instances, climate-related financial risks will not be contained within a single institution or part of the economy. The Fed should consider additional macroprudential analysis to understand how severe weather shocks and pace of decarbonization of the economy can spur contagion concerns.

Question 3: What challenges, if any, could financial institutions face in incorporating these draft principles into their risk management frameworks?

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[27] Federal Register, "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (2022), available at https://www.federalregister.gov/documents/2022/12/08/2022-26648/principles-for-climate-related-financial-risk-management-for-large-financial-institutions.
[28] Board of Governors of the Federal Reserve System, "Pilot Climate Scenario Analysis Exercise" (2023), available at https://www.federalreserve.gov/publications/files/csa-instructions-20230117.pdf.

Data limitations are among the most cited challenges firms face with respect to understanding climate-related financial risks.[29] Accordingly, the Fed should provide guidance as to what types of information may be useful in helping institutions understand their climate risks as well as how banks may obtain this information.

To fully understand their counterparties' and their own operations' climate-related financial risks, banks will need asset-specific data and metrics that are forward-looking. Banks will need information both from counterparties and from public sources to fully understand their exposure to climate-related financial risks.

When making loans, banks typically rely on information disclosed by borrowers, and banks should request climate-related information from their counterparties. The Securities and Exchange Commission's ("SEC") proposed climate disclosure rule provides good examples of the types of information that banks should be requesting from their borrowers,[30] including information about how corporate borrowers' governance policies account for climate risks; the climate-related physical and transition risks likely to have a material impact on borrowers' current and expected assets and operations; borrowers' strategies for addressing those risks; borrowers' Scopes 1, 2, and 3 greenhouse gas emissions (excluding offsets or renewable energy credits); and any other risks that may affect borrowers' creditworthiness in the future. This requested information should relate to both physical- and transition-related risks. Banks should also request geolocation information for significant borrower infrastructure (including significant infrastructure up and down the value chain) and information about whether borrowers have applied for climate-related insurance but have been rejected.

In addition to information provided by borrowers, banks should consider using publicly available data. Useful data sources include publicly traded borrowers' climate- related securities disclosures, borrowers' competitors' climate-related securities disclosures, location-specific climate projections, and information regarding climate risks to borrowers' value chains. Importantly, banks cannot simply rely on historical data to project future trends in climate change; climate events are occurring and intensifying in a nonlinear fashion and will continue to do so into the future.[31] Finally, banks should also consider using independent consultants who have climate-related expertise and knowledge about borrowers' business sectors.

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[29] Board of Governors of the Federal Reserve System, "What are Large Global Banks Doing about Climate Change?" (2023), available at https://www.federalreserve.gov/econres/ifdp/files/ifdp1368.pdf.
[30] Securities and Exchange Commission, "The Enhancement and Standardization of Climate-Related Disclosures for Investors," *Federal Register* 87 (69) (2022): 21334-21473, available at https://www.govinfo.gov/content/pkg/FR-2022-04-11/pdf/2022-06342.pdf.
[31] Christian L. E. Franzke, "Nonlinear climate change," *Nature Climate Change* 4 (2014): 423-424, available at https://www.nature.com/articles/nclimate2245.

Conclusion

The Board's proposed Principles proposed would provide examiners and firms with an integral framework for understanding how banks can identify and mitigate climate-related financial risk. We urge the Fed and fellow federal banking regulators to finalize these Principles expeditiously. As regulators and institutions continue developing their capacity around climate-induced risks, the Fed should issue updated guidance accordingly. We appreciate the opportunity to comment on this proposal.

If you have questions related to the considerations outlined above, please contact Lilith Fellowes-Granda at .

Sincerely,

Center for American Progress